STATEMENT OF DAVID R. STRINE
BEFORE THE
HOUSE TRANSPORTATION AND INFRASTRUCTURE COMMITTEE
SUBCOMMITTEE ON AVIATION

"CONSOLIDATION IN THE AVIATION INDUSTRY, WITH A FOCUS ON THE PROPOSED MERGER BETWEEN UNITED AIRLINES AND CONTINENTAL AIRLINES – A PERSPECTIVE FROM WITHIN THE FINANCIAL MARKETS"

JUNE 16, 2010

Mr. Chairman and members of the Subcommittee, thank you for the invitation to discuss consolidation in the airline industry, with a focus on the proposed United Airlines and Continental Airlines merger. Like you, investors in the capital markets have heard many different arguments about why or why not mergers should take place in the US airline industry. The balance of these arguments and the resulting policy impact how the market prices risk and sets the cost of capital for the Airline industry. To help you with your analysis, I will provide a perspective from within the financial markets.

Fiduciary Duty and Risk

So long as the airlines source their funding from the debt and equity capital markets, the Boards of Directors and management teams have fiduciary duties to their shareholders and creditors. In keeping with that duty, it is incumbent upon company leaders to manage risk and work to enhance returns on invested capital. While managing costs and delivering a product customers value are important, making strategic structural decisions that permit their companies to adapt to changing market conditions are also critical. The airline industry is in dire need of lowering its financial risk and cost of capital. Consolidation is one part of the solution.

Performance – The Industry Consumes Capital and Destroys Value

By several objective measures, the performance of the industry -- including Continental and United -- has been abysmal. The regularity of loss and failure goes unrivaled in corporate America. For example, looking at performance over the past decade, we can see that the industry reported an aggregate loss of $68 billion, there have been 58 bankruptcies, 128,000 jobs (25%) were lost, defined benefit pension plans at several of the nation's largest carriers were off-loaded to the Pension Benefit Guarantee Corporation, and the average age of the US fleet has increased to nearly 11 years. (See tables below.) To cap it off, the value of the XAL (the NYSE Airline Index), has dropped by 77% since 2000. Taken as whole, this body of evidence supports the need for profound change. The leadership at United and Continental are clearly trying to address this need.

Weak Industry Structure and The Cost of Capital

The poor financial performance of the industry through full business cycles can be attributed to its high fixed cost structure, overleveraged balance sheets, low barriers to entry, high barriers to exit, fragmentation, and fierce competition from low-cost domestic carriers and recently-consolidated, well-funded international carriers in Europe, The Middle East, Asia and Latin America. These factors contribute to the high cost of capital, which limits growth. Over the past year, airline asset backed debt has frequently garnered yields over 10%. In one debt transaction, United paid 17%. Further, in the autumn of 2009 every major network carrier except Delta issued equity at steep discounts in transactions that were highly dilutive to shareholders (this raises the cost of equity capital). To this day, the weighted average cost of capital remains well into the double digits because of the significantly overleveraged balance sheets. (See table.) Over the long term, value can only be created when the return on capital exceeds its cost. This is a fundamental financial goal the airline industry has never been able to achieve through a full cycle.

United-Continental -- Too Small to change the Competitive Landscape

Consolidation is not a cure all, but it is self help. While the United-Continental merger is far too small to significantly change the competitive dynamics of the US airline industry given that the two carriers only produce about 18% of the industry's domestic available seat miles and have de minimis route overlap (they do not share any hubs), their focus on improving efficiency and creating synergies is a step in the right direction in the climb toward financial stability. Although labor costs are likely to rise for United-Continental (as they typically do in airline mergers and after reductions after bankruptcy), the scale of the combined entity should enhance purchasing power with suppliers and the global network should be more attractive to high yielding corporate customers. Although United-Continental may gain additional corporate customers which should improve their yield mix, it would be wrong to conclude that the merger will stop domestic yield deterioration due to the continued growth of low cost carrier market share. Any longer term pull back in domestic capacity will be quickly back filled with low-cost capacity. Over the last ten years, network carrier market share has dropped by 33%. (See table below).

Conclusion:

As you weigh policy objectives for the airlines, you may want to consider the benefits from having airlines in a better position to generate a return on invested capital in excess of their cost of capital through a full business cycle. The balance between positions which seek to socialize aspects of the airline industry versus those that promote growth in the free market will contribute to how the market prices airline capital risk and measures the required rate of return to justify growth. The ability to generate more consistent returns on equity and increase free cash flow is the path to repairing balance sheets and longer term financial stability. Only then will there be a solid foundation for increased capital expenditures, rising wages, and increased service.

I look forward to helping you with any questions that you may have.

Respectfully submitted,
David Strine

Airlines That Have Declared Bankruptcy or Ceased Operations Since 2000

Airline Name	Filed	Airline Name	Filed	Airline Name	Filed
Tower Air	2/29/2000	Hawaiian	3/21/2003	Gemini Air Cargo	3/15/2006
Kitty Hawk Aircargo	5/1/2000	Great Plains Airlines	1/23/2004	Traveland	3/1/2007
Pro Air	9/19/2000	Atlas Air/Polar Air Cargo	1/30/2004	Kitty Hawk Aircargo	10/15/2007
Fine Air Services	9/27/2000	Piedmont	9/12/2004	MAXjet Airways	12/24/2007
Legend Airlines	12/3/2000	PSA	9/12/2004	Big Sky	1/7/2008
Reeve Aleutian Airways	12/5/2000	US Airways	9/12/2004	Skyway	1/16/2008
National Airlines	12/6/2000	American Trans Air	10/26/2004	Aloha Airlines	3/31/2008
Allegiant Air	12/13/2000	Pan American Airways/Boston-Maine	11/1/2004	Champion	3/31/2008
Trans World Express	1/10/2001	Southeast Airlines	12/1/2004	American Trans Air	4/2/2008
TWA	1/10/2001	Aloha Airlines	12/31/2004	Skybus Airlines	4/7/2008
Midway	8/14/2001	Westward Airways	7/1/2005	Frontier Airlines	4/11/2008
Midway Commuter	8/14/2001	Delta Air Lines	9/27/2005	Eos Airlines	4/26/2008
Emery Worldwide	12/5/2001	Comair	9/27/2005	Gemini Air Cargo	6/18/2008
Sun Country	1/2/2002	Northwest Airlines	9/27/2005	Air Midwest (Mesa Air Group)	6/30/2008
CCAir	7/1/2002	TransMeridian Airlines	9/29/2005	Vintage Props & Jets	7/18/2008
Vanguard Airlines	7/30/2002	Mesaba	10/13/2005	Zoom Airlines	9/3/2008
Piedmont	8/11/2002	FLYI Independence Air	11/7/2005	Sun Country	10/6/2008
PSA	8/11/2002	Era Aviation	12/28/2005	Primaris Airlines	10/15/2008
US Airways	8/11/2002	Florida Coast Airlines	2/21/2006	Mesa Air Group	1/5/2010
United Airlines	12/9/2002				

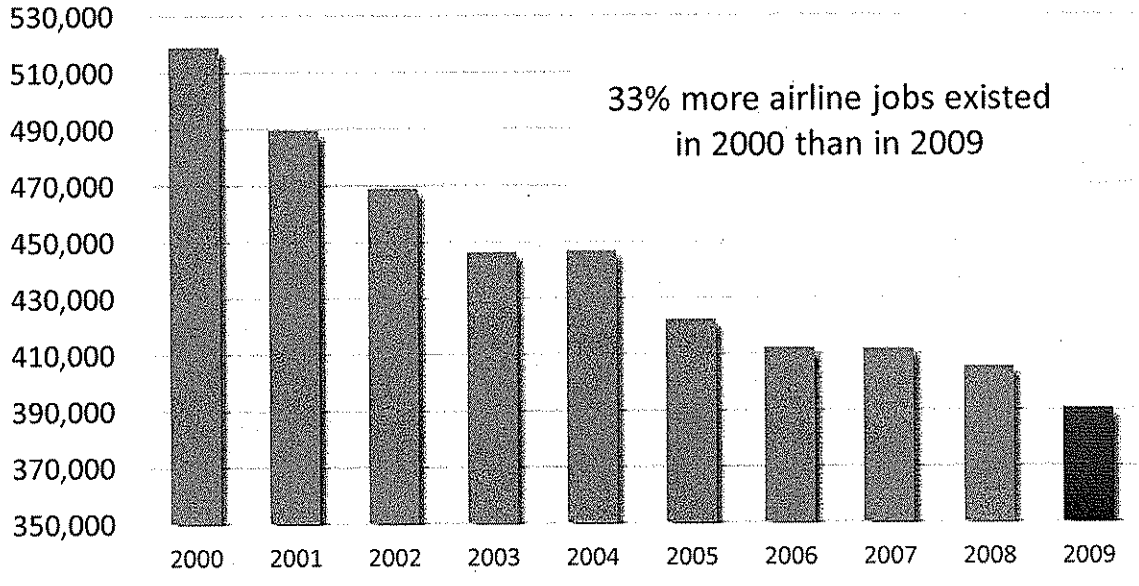
Shaded carriers filed twice during 2000-2010

Source: Air Transport Association, DOT and ALPA E&FA

Source: Airline Forecasts

128,500 FTE Airline Jobs lost over the last 10 years

(All passenger airlines - 58 in total)



Source: DOT & AirineForecasts

2009 Market Share - ASMs and RPMs

	Domestic-only in %	ASMs	RPMs
1	United+Continental	17.7	18.4
2	Delta+Northwest	16.1	16.8
3	Southwest	14.6	13.7
4	American	13.9	14.1
5	US Airways	7.9	8.1
6	JetBlue	4.3	4.2
7	AirTran	3.4	3.4
8	Alaska	3.2	3.1
9	Frontier	1.5	1.5
10	Hawaiian	1.3	1.4
11	Virgin America	1.0	1.0
12	Spirit	0.9	0.9
13	Allegiant	0.7	0.8
	Top 13 airlines	86.5	87.4
	Regionals & Others	13.5	12.6

AirlineForecasts

2009 Market Share - ASMs and RPMs

	Systemwide in %	ASMs	RPMs
1	United+Continental	22.9	23.4
2	Delta+Northwest	20.7	21.3
3	American	16.0	16.1
4	Southwest	10.4	9.8
5	US Airways	7.5	7.6
6	JetBlue	3.4	3.4
7	AirTran	2.5	2.4
8	Alaska	2.4	2.4
9	Frontier	1.1	1.1
10	Hawaiian	1.0	1.1
11	Spirit	0.8	0.8
12	Virgin America	0.7	0.7
13	Allegiant	0.5	0.6
	Top 13 airlines	90.0	90.7
	Others/Regionals	10.0	9.3

AirlineForecasts

Source: Airline Forecasts

Market Share in Available Seat Miles (ASMs)

Percentage of total domestic-only ASMs

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	% chg
Network Airlines	81%	80%	78%	75%	69%	66%	64%	61%	58%	57%	56%	*-33%*
Southwest	8%	8%	10%	10%	11%	11%	11%	13%	13%	14%	15%	*88%*
Other	11%	12%	13%	14%	20%	23%	25%	26%	28%	29%	30%	*173%*

DOT & AirlineForecasts

Capital Sturcture Deficit

		Market Equity	Book Equity	Intangible assets	Tangible Equity	Total Assets	Tangible Book equity to Assets
1	Allegiant	1,016	292		292	500	58%
2	Southwest	9,574	5,220		5,537	14,530	38%
3	Jeblue	1,667	1,510		1,534	6,513	24%
4	AirTran	705	487		487	2,286	21%
5	Alaska	1,583	774		885	5,016	18%
6	Continental	2,836	497	774	(277)	13,318	-2%
7	US Airways	1,100	(447)	616	(1,063)	7,808	-14%
8	American	2,311	(3,892)	981	(4,873)	25,525	-19%
9	Delta	9,759	72	9,794	(9,722)	44,339	-22%
10	United	3,265	(2,887)	2,863	(5,750)	19,952	-29%
	Top 10	**33,816**	**1,625**	**15,028**	**(12,950)**	**139,786**	-9%
	UAL/CAL	6,101	(2,390)	3,637	(6,027)	33,270	-18%

AirlineForecasts

Passenger Airlines: Revenue and Earnings

	Passenger Revenue	Operating revenue	Operating profits	*margins*	Net Income	*margins*
In 2009$	*($millions)*	*($millions)*	*($millions)*	*(%)*	*($millions)*	*(%)*
1977	57,510	68,744	3,094	4.5%	2,367	3.4%
1978	61,807	73,154	4,341	5.9%	3,869	5.3%
1979	67,255	78,455	594	0.8%	948	1.2%
1980	72,522	83,536	(498)	-0.6%	126	0.2%
1981	71,522	81,702	(1,011)	-1.2%	(579)	-0.7%
1982	67,197	76,834	(1,558)	-2.0%	(1,853)	-2.4%
1983	69,879	79,308	646	0.8%	(250)	-0.3%
1984	75,408	85,750	4,107	4.8%	1,488	1.7%
1985	77,191	87,982	2,658	3.0%	1,780	2.0%
1986	76,544	87,551	1,903	2.2%	(121)	-0.1%
1987	84,584	96,567	3,513	3.6%	328	0.3%
1988	91,126	103,221	5,121	5.0%	2,393	2.3%
1989	92,973	105,307	2,169	2.1%	(143)	-0.1%
1990	95,739	108,634	(4,004)	-3.7%	(6,755)	-6.2%
1991	89,965	102,577	(3,581)	-3.5%	(3,214)	-3.1%
1992	91,507	103,792	(4,265)	-4.1%	(7,133)	-6.9%
1993	95,020	108,110	1,271	1.2%	121	0.1%
1994	94,394	108,047	2,832	2.6%	(976)	-0.9%
1995	97,449	111,337	7,198	6.5%	2,791	2.5%
1996	102,472	115,854	7,287	6.3%	3,279	2.8%
1997	105,856	120,427	9,875	8.2%	6,313	5.2%
1998	106,113	121,013	10,506	8.7%	5,779	4.8%
1999	108,132	123,576	8,886	7.2%	5,999	4.9%
2000	116,091	130,956	7,108	5.4%	2,796	2.1%
2001	97,521	111,293	(12,529)	-11.3%	(9,690)	-8.7%
2002	87,092	100,200	(11,344)	-11.3%	(13,974)	-13.9%
2003	89,777	108,152	(3,532)	-3.3%	(2,429)	-2.2%
2004	96,747	120,956	(3,799)	-3.1%	(11,379)	-9.4%
2005	102,182	130,369	(2,145)	-1.6%	(31,406)	-24.1%
2006	107,660	138,902	5,351	3.9%	17,575	12.7%
2007	110,650	142,326	6,911	4.9%	6,519	4.6%
2008	110,641	145,162	(5,424)	-3.7%	(23,887)	-16.5%
2009	91,259	123,224	992	0.8%	(2,830)	-2.3%
78-09	**2,904,276**	**3,414,270**	**39,581**	**1.2%**	**(54,517)**	**-1.6%**

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	2009$	*($millions)*	*($millions)*	*($millions)*	*(%)*	*($millions)*	*(%)*
10-yrs	80-89	778,947	887,757	17,052	1.9%	3,168	0.4%
10-yrs	90-99	986,648	1,123,366	36,005	3.2%	6,204	0.6%
10-yrs	00-09	1,009,620	1,251,539	(18,411)	-1.5%	(68,706)	-5.5%
30-yrs	80-09	2,775,215	3,262,662	34,646	1.1%	(59,334)	-1.8%
31-yrs	**79-09**	**2,842,470**	**3,341,116**	**35,240**	1.1%	**(58,386)**	**-1.7%**

AirlineForecasts